Institutional Distance and the Monitoring Effect of Foreign Investors

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We investigate whether the effectiveness of foreign investors in monitoring local firms is affected by the institutional distance between their home and host countries. Based on a group of Chinese listed firms, we show that local firms' financial reporting quality and corporate governance efficacy are both negatively associated with the formal and informal institutional distances between foreign investors' home countries and host country, i.e., China. The evidence is consistent with the conjecture that institutional distance exacerbates the difficulty faced by foreign investors in monitoring local firms in China, and increases their monitoring costs, which in turn increases managerial opportunism in general and decreases local firms' financial reporting quality in particular. Moreover, we find that by appointing directors on the boards of local firms, foreign investors could mitigate the adverse impact of formal institutional distance on their monitoring effectiveness, but not the adverse consequences resulting from informal institutional distance (e.g., cultural differences). We also find that severe institutional distance adversely impacts local firms' operational performance and market valuation, suggesting that it constrains foreign investors from taking value-enhancing actions in local firms.

Key words: Institutional distance; foreign investors; financial reporting quality; corporate governance

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1. Introduction

With globalization of financial markets, the role of foreign investors in monitoring local firms has received considerable attention from academic researchers and business executives. One strand of research claims that foreign investors tend to have a significant amount of investment experience and expertise, and thus their presence has a positive impact on corporate governance and monitoring effectiveness in general and financial reporting quality in particular. Aggarwal, Erel, Ferreira, and Matos (2011) document that the presence of foreign shareholders from countries with strong investor protection improves the governance mechanisms of local firms domiciled in countries with weak investor protection. Seasholes (2000) and Grinblatt and Keloharju (2000) posit that foreign investors have access to better resources and expertise than local investors. Gillan and Starks (2003) and Ferreira and Matos (2008) contend that foreign investors take a more active role in improving corporate governance as they are more independent than domestic investors. However, the other stand of research argue that foreign investors are less informed about local firms than local investors in the host country (e.g., Hau, 2001; Choe, Kho, and Stulz, 2005; Dvorak, 2005): they may have to bear additional costs (e.g., information acquisition cost, communication cost, enforcement cost, etc) to overcome their informational disadvantage in monitoring local firms. This line of research in general predicts that foreign investors are less effective in monitoring local firms than domestic investors.

The relative informational disadvantage that foreign investors have over local investors stems from the fact that investors from foreign countries face a significant liability of "foreignness" in the host countries where they invest, because these investors have to encounter and overcome various challenges arising from geographic and institutional differences between home and host countries (Zaheer, 1995). In this paper, we extend the strand of research in the efficacy of external monitoring by foreign investors. In so doing, our analysis focuses mainly on whether and how institutional distance between home and host countries influences the ability of foreign investors in monitoring local firms. We maintain that foreign investors have better expertise and are more independent than domestic investors in monitoring local

firms, but they are faced with greater informational disadvantage. We further maintain that the informational disadvantage increases with institutional distance. Under the above maintained assumptions, we predict that the institutional distance between foreign investors' home and host countries adversely affect the efficacy of foreign investors' monitoring of local firms.

We test the above prediction using a sample of firms listed on China's stock markets for the following reasons. First, foreign investors, particularly foreign institutional investors, are very active in China's stock markets. Over the past two decades, China's economy has experienced a phenomenal growth. Not surprisingly, China's stock markets are now attracting institutional investors from foreign countries around the world. The Chinese government offers many preferential policies to foreign investors in an effort to boost foreign equity investments.[1] Studying the role of foreign investors in monitoring local firms in China is therefore interesting and important in its own merit. Second, shareholder protection is still weak in the Chinese market, and corporate governance is an important issue for Chinese listed firms. Both the Chinese government and investors are hoping that the participation of foreign investors in the market would facilitate Chinese local firms enhancing the efficacy of corporate governance and external monitoring.[2] Third, investor protection in the U.S. stock markets is considered to be the strongest in the world, while corporate governance efficacy and financial reporting quality of U.S. firms are viewed as the highest among countries around the world. Therefore, foreign investors in the U.S. market are *unlikely* to play an important role in influencing U.S. firms' corporate

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[1] The Chinese government has always been active in attracting foreign investments. Before 2001, it was mainly in the form of foreign direct investment. In an attempt to literalize the stock market for foreign investors, China Securities Regulatory Commission (CSRC) introduced the Qualified Foreign Institutional Investors (QFII) scheme in 2002, allowing licensed foreign investors to trade A-share stocks. Prior to QFII, foreign investors were not able to trade A-shares on China's exchanges. In 2006, CSRC took important steps to further attract foreign investors to the Chinese equity markets, including lowering the entry barrier for foreign institutional investors to the A-share market (Gul, Kim, and Qiu, 2010). In 2011, China further launched the RMB Qualified Foreign Institutional Investors (RQFII) scheme to allow exchange-traded funds raised offshore to be invested in the domestic capital market. By the end of April, 2015, the number of enterprises under QFII and RQFII was brought to 281 and 152, respectively. And overseas institutions have received QFII quotas amounting to $73.62 billion, and the volume under the RQFII program totalled 363.7 billion yuan (approximately $58.66 billion).

[2] For instance, in releasing the" Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors" in 2005, the Chinese government states that its purpose of actively attracting foreign investments include " maintaining the order of securities market, introducing advanced overseas management experiences, technologies and capital, and improving the corporate governance of the listed companies".

governance and monitoring as well as their financial reporting. In contrast, China's stock markets are still in the developing stage and foreign investors are likely to play a significant role in influencing local firms' corporate governance and external monitoring. Therefore, China's stock markets provide an ideal setting in which to examine the role of foreign investors in monitoring local firms in host countries or simply the monitoring effectiveness of foreign investors in China. Finally, as foreign investors in China's stock markets come from different countries with differing institutional infrastructure, there is a wide variation in the institutional backgrounds of foreign investors in China's stock markets. This facilitates our investigation into the impact of institutional distance on the effectiveness of external monitoring by foreign investors in China.

Following the existing literature, we measure institutional distance in two different ways: formal and informal distances. Formal institutional distance focuses on a set of political, economic and contractual rules and laws that influence business strategies and operations. In contrast, informal institutional distance, which origins from culture differences, involves rules embedded in values, norms and beliefs. Both formal and informal institutional distances add to the informational disadvantage faced by foreign investors and the costs associated with foreign investors' monitoring of local firms. Formal institutional distance makes it costly for foreign investors to learn the laws and regulations of the host country and adapt to the business models of local firms. As prior studies suggest, formal institutional distance increases international investment risk and decreases the performance of international investments (e.g., Mudambi and Navarra, 2002; Delios and Henisz, 2003; Wright, Filatotchev, Hoskisson, and Peng, 2005; Li, Vertinsky, and Li, 2014). Informal institutional distance, on the other hand, raises barriers to information sharing, reduces mutual trust, and makes it difficult for foreign investors to effectively communicate and coordinate with local firms. Mian (2006) reports that greater cultural and geographical distances deter foreign banks from lending to firms that are "informationally difficult" even if they are fundamentally sound. Giannetti and Yafeh (2012) find similar evidence.

We therefore predict that, for firms with the presence of foreign investors, the quality of financial reporting and the efficacy of corporate governance are both negatively related to not only formal, but also informal, institutional distances between the home and host countries of foreign investors.

Our empirical strategy involves obtaining empirical proxies for financial reporting quality and governance and/or monitoring efficacy. Following prior research in accounting (e.g., Aboody, Hughes, and Liu, 2005; Dechow,Ge,and Schrand, 2010; Beyer, Cohen, Lys, and Walther, 2010) , we measure financial reporting quality using: (i) accruals quality; and (ii) management's tendency to voluntarily issue management earnings forecasts (MF) and the accuracy of MF. And we measure the efficacy of corporate governance and/or external monitoring using: (i) executive compensation; and (ii) insider trading profit. Managerial compensation and pay-for-performance sensitivity has been widely used in the literature to capture governance efficacy (e.g., Ke, Petroni, and Safieddine, 1999; Hartzell and Starks, 2003; Hartzell and Starks, 2003; Masulisa,Wang, and Xie, 2012;). Ke, Rui, and Yu (2012) examine the pay-for-performance sensitivity among state-controlled Chinese firms. Besides, past studies suggest that insider trading profit is higher for firms with weaker governance, and that effective external monitoring could mitigate informed trading by corporate insiders. (e.g., Jagolinzer, Larcker, and Taylor , 2011; Skaife, Veenman, and Wangerin, 2013; Jerry, Parwada, and Zhang, 2015).

We also investigate whether foreign investors can ameliorate the adverse impact, if any, of institutional distance on their monitoring effectiveness. More specifically, we examine whether this adverse impact can be attenuated by foreign investors by appointing directors on the boards of local firms. Prior studies provide evidence that foreign investors might improve their ability to monitor local firms via the appointment of foreign directors on the boards of local firms (e.g., Choi, Park, and Yoo, 2007). This evidence suggests that the directors appointed by foreign investors tend to oversee the operation as well as the production of financial information in local firms more closely than the directors appointed by local investors. Besides, foreign investors' appointment of directors on the boards of local firms may facilitate

foreign investors being acquainted with local firms' business environments, domestic accounting standards and rules, laws and regulations, governance practices, management styles, and alike. Thus, we expect the adverse impact of institutional distance on local firms' financial reporting quality and corporate governance efficacy to be attenuated among firms with directors appointed by foreign investors.

We follow the literature to measure formal and informal institutional distances between China and the home countries of foreign investors. We construct the formal institutional distance index using the World Governance Indicators (WGI) issued by the World Bank. The WGI indicators capture a country's governance efficacy based on five dimensions, that is: (i) voice and accountability; (ii) governance effectiveness; (iii) regulatory quality; (iv) rule of law; and (v) control of corruption. Many prior studies have relied on these dimensions to measure the formal institutional distance between nations (e.g., Detragiache, Tressel, and Gupta, 2008; Siegel, Licht, and Schwartz, 2011). We rely on Hofstede's (1980, 2001) culture indices to quantify the informal institutional distance between nations. These culture indices are based on five culture-related dimensions, that is: (i) power distance; (ii) individualism; (iii) masculinity; (iv) uncertainty avoidance; and (v) long-term orientation. This approach has also been widely used in the prior literature (e.g., Ahern, Daminelli, and Fracassi, 2012; Giannetti and Yafeh, 2012; Nahata, Hazarika, and Tandon, 2013).

Briefly, our findings can be summarized as follows: First, we find that local firms with foreign investors from more institutionally distant countries tend to have lower financial reporting quality in that these firms have lower accruals quality. Moreover, management's tendency to issue voluntary forecasts and their forecast accuracy both decrease with the institutional distance between China and foreign investors' home countries. It is consistent with our prior that institutional distance deters foreign investors from effectively monitoring local firms, resulting in lower financial reporting quality and greater information asymmetry.

In terms of corporate governance, we find that the amount of executive compensation is positively associated with the institutional distance between China and the home countries of foreign investors, while the sensitivity of executive

compensation to firm performance is negatively associated with the institutional distance. Moreover, when the institutional distance is long (i.e., severe), insiders of the firm are better able to generate higher profits from trading the stocks of their own firm. The evidence is consistent with our expectation that it is more difficult for foreign investors to collect information and monitor insiders of local firms effectively, as the institutional distance is greater.

We find that the negative impact of institutional distance on the monitoring effectiveness of foreign investors is at least partially mitigated when foreign investors appoint directors on the boards of local firms. More specifically, we find that that director appointment by foreign investors contributes to mitigating the adverse impact resulting from long, formal institutional distance, but not from long, informal institutional distance. The result is not surprising as the influence imposed by institutional distance arising from culture or informal institutional difference is difficult to overcome, as it is deeply rooted in human psyche. As Becker (1996; p.16) states, "individuals have less control over their culture than over other social capital. … Because of the difficulty of changing culture and its low depreciation rate, culture is largely a 'given' to individuals throughout their lifetimes."

To address the potential endogenous issues, we take advantage of China's adoption of new accounting standards in 2007 to examine its impact on the relation between institutional distance and the monitoring effectiveness of foreign investors. Before 2007, China operated a largely rules-based accounting regime. Since 2007, all listed firms are required to report under the IFRS-converged new accounting standards, which are principle-based. The convergence of China's standards with IFRS is a significant milestone in the process of harmonizing international accounting standards. The enforcement of the new accounting standards introduces an exogenous shock to the institutional distance, especially formal institutional distance, between countries that have adopted IFRS and China. The enforcement makes it easier for foreign investors from IFRS-adopted countries to understand the financial information of local firms listed on China's stock markets. We thus expect the adverse impact of formal institutional distance on local firms' financial reporting quality and governance

efficacy to be attenuated for firms with foreign investors from IFRS-adopted countries, but not for firms with foreign investors from non-IFRS countries. We provide empirical evidence that is consistent with our expectation, which enriches and buttresses our main findings.

In our robustness checks, we examine the *change* in local firms' financial reporting quality and governance efficacy after the entrance of foreign investors, and find that it is also negatively related to institutional distance, further alleviating concerns about potential endogeneity. In our subsample tests, we find that the adverse impact of institutional distance on the ability of foreign investors to monitor local firms is concentrated on the subsample of firms with foreign investors who do not have business operation or investment experience in China before. Once they have gained some exposures to the Chinese markets, the negative influence of institutional distance is largely attenuated. And we also show that our results are not likely to be driven by cross-country differences in corporate governance practices, and remain robust if we exclude firms that simultaneously issuing foreign shares.

Finally, we find that long institutional distance between the home and host countries of foreign investors has a negative impact on both the operational performance and market valuation of local firms. The finding is consistent with our expectation that as institutional distance reduces the monitoring effectiveness of foreign investors, it deteriorates firm performance and market valuation.

Our study contributes to the existing literature in the following way. First, our results reveal that the monitoring effectiveness of foreign investors is inversely affected by the institutional distance between their home and host countries. Existing studies show that foreign investors help local firms (in which they invest) to improve their financial reporting quality and corporate governance efficacy, because foreign investors are more independent from local firms and have relatively rich experience in monitoring local firms (e.g., Ferreira and Matos, 2008; Guedhami, Pittman, and Saffar, 2009; Aggarwal et al., 2011, Liang, Lin, and Chin, 2012; Fang et al., 2015). Our study is one of the few, if not the first, studies to examine the impact of institutional distance in the context of the difficulty faced by foreign investors and the costs to them of

monitoring local firm. Second, our study also adds to the literature on the "liability of foreignness." Past studies have documented that foreign investors are faced with higher information costs than local investors, thus achieving lower trading profits (Hau, 2001; Choe, Kho, and Stulz, 2005; Dvorak, 2005). Our study further show that the liability of foreignness resulting from greater formal and informal institutional distances would constrain the monitoring effect of foreign investors, which in turn adversely affects the operational performance and market valuation of local firms. Moreover, we show that, by appointing directors on the boards of local firms, foreign investors can mitigate the negative consequences of formal institutional distance, but not of informal institutional distance.

The remainder of the paper proceeds as follows. Section 2 introduces sample and variables. Section 3 provides evidence on the monitoring effect of foreign investors. Sections 4 and 5 examine whether and how institutional distance is related to local firms' financial reporting quality and corporate governance efficacy. Section 6 investigates the consequences of the enforcement of new Chinese Accounting Standards. Section 7 performs robustness checks. Section 8 examines the influence of institutional distance on local firms' operational performance and market valuation. Section 9 concludes.

2. Data and Methodology

2.1. Sample and data source

We focus on Chinese listed firms with foreign equity investors. Data on shareholders are obtained from the CSMAR database maintained by GTA. Our sample covers all nonfinancial firms that are publicly traded on the A-share market from 1999 to 2012 in mainland China.[3] Financial firms are excluded as they are subject to different accounting rules, making it difficult to compare their financial reporting quality with that of other firms. And we require sample firms to have foreign investors among their top ten largest shareholders, as the detailed information on shareholders is only provided for those who are on the top ten shareholder list.

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[3] Our sample period starts from 1999 as CSMAR only provides data on the top ten shareholders since that year.

Chinese listed firms issue A-shares to domestic investors. Some of these listed firms also issue foreign shares, such as B-shares (traded on the Shanghai or Shenzhen exchange) or H-shares (traded in Hong Kong). Before 2002, foreign investors could not trade A-shares on China's exchanges because of China's tight capital control. They could only invest in A-share firms through channels such as direct investment, or purchasing foreign shares of the firms, if there are any. In 2002, CSRC introduced QFII scheme which allows licensed foreign investors to invest A-shares under certain constraints. Since 2011, foreign investors are further allowed to trade A-shares through RQFII scheme. Thus, although our sample focuses on firms listed on the A-share market, foreign investors could obtain their ownership of the firm from different channels.

We manually search the internet and firms' annual reports to identify the types of foreign investors on the top ten shareholder list of sample firms. The foreign investors examined in this study include foreign financial institutions, foreign corporations, or foreign individuals, but not foreign branches of Chinese firms. International venture capitals or mutual funds managed by Chinese offices are also excluded, as their investment and corporate engagement decisions are made by local offices rather than headquarters (Kim, Sung, and Wei, 2014). We also exclude from our sample foreign investors holding less than the 1% of local firms' shares, as such investors are unlikely to have a significant influence over local firms and are less motivated to actively engage in the monitoring activities. We delete observations with missing financial information or negative book equity values. The final sample consists of 189 unique firms and 990 firm-year observations.

For our sample of firms with foreign investors, we hand-collect information about the nationality of foreign investors and their director appointment from firms' annual reports and prospectus, or through the internet. If a local firm has more than one foreign investor among its top ten largest shareholders, we rely on the origin of the "lead" foreign investor to calculate the institutional distance. A lead foreign investor is the one with the greatest foreign ownership. In a few cases where two foreign investors have a similar level of ownership in a local firm, we identify the one

that enters the firm earlier as the lead foreign investor.

Table 1 summarizes the distribution of our sample firms with forging investors during the period from January 1999 to December 2012. The number of Chinese listed firms with foreign investors being one of the top ten shareholders increases from 41 in 1999 to 125 in 2012, consistent with the fact that the Chinese market is attracting more and more foreign investors over time. The last two columns of Table 1 show that the average foreign equity ownership increases from 16.9% in 1999 to 24.8% in 2012 with an average of around 18% for our sample, and that around 70% of firms in our sample have foreign investors acting as directors on their boards.

[Insert Table 1 here]

2.2. Measurement of key research variables.

2.2.1. Formal and informal institutional distances

We follow the literature (e.g., North, 1990) to construct formal and informal institutional distance measures. Formal institutional distance focuses on the differences in political rules and laws, legal enforcements, and economic issues between foreign investors' home countries and China, while informal institutional distance concerns more about cultural and ideological differences.

We use the Worldwide Governance Indicators (WGI) issued by the World Bank to measure the formal institutional distance between two nations. According to the World Bank, the "Governance" of a country is defined as the traditions and institutions by which authority is exercised, including: (i) the process by which governments are selected, monitored and replaced; (ii) the capacity of the government to effectively formulate and implement sound policies; and (iii) the respect of citizens and the state for the institutions that govern economic and social interactions. We employ WGI to measure formal institutional distance from five perspectives, including voice and accountability, governance effectiveness, regulatory quality, rule of law, and control of corruption.

We utilize the cultural indices of Hofstede (1980, 2001) to measure the informal institutional distance between nations. Hofstede categorizes culture into five dimensions, that is: (i) small versus large power distance; (ii) high versus low

uncertainty avoidance; (iii) individualism versus collectivism; (iv) masculinity versus femininity; and (v) short-term versus long-term orientation. He studies these five dimensions using survey responses from over 88,000 employees of IBM in 40 countries speaking 20 different languages in the 1960s and 1970s.

Following the methodology that Kogout and Singh (1988) employed in constructing their culture distance index, we measure institutional distance as the average of the squares of the difference in institutional attribute score between the foreign investors' home countries and China, scaled by the variance of the attribute score. For each foreign investor, the formal institutional distance between its home country and China, denoted by *ID*, is defined as:

$$ID = \sum_{k=1}^{n} \frac{(I_{kj} - I_{kc})^2}{VAR_k \cdot n}, \qquad (1)$$

where I_{kj} represents to the kth formal institution attribute score of the foreign country, I_{kc} is the kth formal institution attribute score of China, VAR_k is the variance of the kth formal institution attribute score among the 20 foreign countries in our sample, and *n* is the number of formal institutional attributes (*n* =5).

For each home country of foreign investors, we define its informal institutional distance to China (*CD*) as:

$$CD = \sum_{s=1}^{m} \frac{(I_{sj} - I_{sc})^2}{VAR_s \cdot m}, \qquad (2)$$

where I_{sj} is the sth informal institution attribute score of the foreign country, I_{sc} is the sth informal institution attribute score of China, VAR_s is the variance of the sth informal institution attribute score among 20 countries, and *m* is the number of formal institutional attributes (*m* =5).

Both formal and informal institutional distances between the 20 foreign countries in our sample and China are presented in Table 2. Compared with Western countries, most Asian countries and regions are closer to China in terms of both formal and informal institutional distances. The exceptions are Hong Kong and Singapore, which are close to China in terms of informal institutional distance but distant in terms of formal institutional distance. This is not surprising as Hong Kong and Singapore share similar culture background with China, but have very different

institutional background as they were both British colonies and have adapted themselves to the Western practices. Among the 20 countries, in terms of formal institutional distance, countries that are most distant from China are Denmark (8.205), Netherlands (7.497) and New Zealand (7.456), and those that are the closest are Vietnam (0.145), Thailand (0.726) and India (0.838). With respect to informal institutional distance, Denmark (5.342), Austria (5.286) and Netherlands (4.913) are the most faraway from China, while Hong Kong (0.253), Vietnam (0.817) and India (1.205) are the most nearby.

[Insert Table 2 here]

Table 2 also shows that out of 990 firm-year observations, 330 have investors from Hong Kong, accounting for more than 33% of the total observations. This is as expected given the close relationship between mainland China and Hong Kong. It is the least common to find foreign investors from Canada and Australia among the top ten largest shareholders in Chinese local firms, with only three and one observations respectively. Investors from Vietnam have the highest ownership, with an average of 37.5% in a single local firm. The director appointment indicator, or *Board*, equals one for firms with foreign investors from Austria, Belgium or Vietnam, suggesting that investors from these three countries appoint at least one director on the board of every local firm for which they are among the top ten largest shareholders.

2.2.2. Accruals quality

Accrual quality, denored by AQ_1, is measured following Dechow and Dichev (2002). Specifically, we perform the following regression:

$$\frac{\Delta WC_{it}}{TA_{it-1}} = l_0 + l_1 \left(\frac{CFO_{it-1}}{TA_{it-2}}\right) + l_2 \left(\frac{CFO_{it}}{TA_{it-1}}\right) + l_3 \left(\frac{CFO_{it+1}}{TA_{it}}\right) + \varepsilon_{it}, \tag{3}$$

where, for each firm i in each year t-1, t, or t+1, ΔWC is change in working capital; TA is total assets; and CFO refers to cash flows from operations.[4] AQ_1 is defined as the absolute value of the residual from Eq. (3).

We follow McNichols' (2002) to construct our second accruals quality measure,

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[2] The change in working capital is measured as follows: $\Delta WC_{it} = \Delta CA_{it} - \Delta CASH_{it} - \Delta CL_{it} + \Delta STDDEBT_{it}$, where ΔCA_{it}, $\Delta CASH_{it}$, ΔCL_{it}, and $\Delta STDDEBT_{it}$ are changes in current assets, cash flow, current liabilities, and short-term debt for firm i, respectively, in year t.

denoted by AQ_2. Specifically, we estimate a modified Dechow and Dichev's (2002) model as specified below:

$$\frac{\Delta WC_{it}}{TA_{it-1}} = k_0 + k_1 \left(\frac{CFO_{it-1}}{TA_{it-2}}\right) + k_2 \left(\frac{CFO_{it}}{TA_{it-1}}\right) + k_3 \left(\frac{CFO_{it+1}}{TA_{it}}\right) + k_4 \left(\frac{\Delta SALE_{it}}{TA_{it-1}}\right) + k_5 \left(\frac{\Delta PPE_{it}}{TA_{it-1}}\right) + \varepsilon_{it}, \quad (4)$$

where, for each firm i and each year t-1, t or $t+1$, $\Delta SALE$ is the change in sales, and ΔPPE is the change in property, plant and equipment; and all other variables are as defined in Eq. (3). AQ_2 is the absolute value of the residual from Eq. (4). Higher AQ_1 and AQ_2 indicate lower accruals quality.

2.2.4. Voluntary forecast disclosure

We use two more variables, the likelihood that managers voluntarily issue forward-looking disclosure (*VFD*) and management forecast error (*MFE*), to capture financial reporting quality from the perspective of management's voluntary disclosure. Data on management earnings forecasts (MFs) for Chinese listed firms are obtained from the Wind database. There are two types of management earnings forecasts in the Chinese market: voluntary and mandatory. Managers are required to make earnings forecasts if they anticipate that the earnings change, relative to that over the last year, would exceed 50% or the firm is likely to incur a loss in the current year. Other earnings forecasts are viewed as voluntary ones. As Wind only provides narrative descriptions on firms' MFs, we manually identify the forecast type (voluntary versus mandatory) and focus only on the voluntary MFs. We also hand-collect managers' earnings estimates, i.e., MFs, to calculate the forecast error. *VFD* is a dummy variable that equals one if a firm voluntarily issues at least one earnings forecast for the current year, and zero otherwise. *MFE* is the absolute value of the difference between management earnings forecast and the realized earnings, scaled by the absolute value of the realization. When a firm issues multiple MFs for a given year, we retain only the first MF to compute MFE, as the first MF is likely to be more biased than updated forecasts (Karamanou and Vafeas, 2005; Xu, 2010). MFs take form of either a point forecast or the midpoint of a range forecast in the first MF.

2.2.5. Management compensation and trading profits of corporate insiders

We measure a firm's governance quality using three different proxies: (i)

level of management compensation; (ii) pay-for-performance sensitivity; and (iii) insider trading profit obtained by corporate insiders. The level of management compensation is calculated as the natural logarithm of executive compensation (the sum of the three highest compensations for a firm's executives) at the fiscal year end. The pay-for-performance sensitivity is measured using the coefficient obtained from regressing executive pay on return-on-asset (ROA). Insider trading profit is captured by the cumulative abnormal return of the stock of the local firm over a 120-day window beginning from the trading date of local firms' insiders, denoted by CAR(1,120).[5] We obtain executive compensation data from the CSMAR database. We collect insider trading data from Wind, and manually identify the transactions made by corporate insiders, based on identification of the traders.

2.2.6. Tobin's Q

Following prior research (e.g., Ferreira and Matos, 2008; Aggarwal et al., 2011), we measure firm's market valuation using Tobin's Q. It is constructed by dividing the market value of equity plus book value of debt by the book value of assets at the fiscal year end. In unreported tests, we also construct an alternative Tobin's Q measure by using book value of tangible assets as the denominator, to reduce the potential noise associated with the valuation of intangible assets. The empirical results are not affected if we employ the alternative Tobin's Q measure in the tests. All the data required to measure Tobin's Q are obtained from CSMAR.

2.3. Measurement of control variables

Control variables used in our empirical investigation include shareholder concentration (*OwnCon*) measured by the ownership of the largest shareholder divided by that of the second largest shareholder, firm size measured by the natural logarithm of total assets (*LogTA*), the nature logarithm of market capitalization (*LogMV*), book-to-market ratio (*BM*), loss indicator (*Loss*), leverage (*LEV*) measured by total debt scaled by total assets, return on assets (*ROA*), return over the prior month (*PastMonthRet*), and return over the prior year (*PastYearRet*). To alleviate potential

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[3] We first estimate market beta for the stock over a 90-day period ending 30 days before the trading date, and apply the estimated market beta to calculate the stock's abnormal return over the period after the insider trading date.

problem of outliers, we winsorize all variables at the top and bottom 1% of their empirical distributions. All the accounting data are obtained from CSMAR. A detailed description of the variables is provided in Table A-1 in Appendix.

3. The Impact of External Monitoring by Foreign Investors

3.1. Baseline difference-in-differences regressions

If foreign investors are effective monitors of local firms in which they invest (e.g., Guedhami et al., 2009; Aggarwal et al., 2011; Fang et al., 2015), we predict that financial reporting quality and corporate governance efficacy of local firms improve from the pre-period (before the entrance of foreign investors) to the post-period (after the entrance of foreign investors), compared with the improvement for local firms with no foreign investors for the same period. We test this prediction using a difference-in-differences research design: For each firm with foreign investors (i.e., treatment firms) in each year, we identify and match three control firms with no foreign investors that satisfy the following criteria: (i) control firms should be in the same industry as the treatment firm; (ii) the size of a control firm should be within the range of 70% to 130% of the size of a treatment firm; and (iii) control firms should have a book-to-market ratio that is the closest to that of treatment firms. We then estimate the following difference-in-differences regression that links the economic consequences of foreign equity ownership with our test variables, i.e., *FOR, POST,* and *FOR*POST*, and control variables:

$$DV_{it} = \alpha_0 + \alpha_1 FOR_{it} + \alpha_2 POST_{it} + \alpha_3 FOR_{it}*POST_{it} + (Controls) + (error) \qquad (5)$$

In the above equation, where *FOR* is an indicator variable that equals one if the firm has ever been invested by foreign investors, and zero otherwise; *POST* is an indicator variable that equals one for observations after the first-time entrance of foreign investors, and zero otherwise. In Eq. (5), the dependent variable, *DV,* refers to financial reporting quality (e.g., accrual quality) or governance efficacy (e.g., compensation level or insider trading profit). As will be further explained later on, Eq. (5) will be appropriately modified, depending on our research questions in hand.

3.2. The impact of foreign investors' monitoring on financial reporting quality

We first estimate Eq. (5) using, as the dependent variable, accrual quality as our proxy for financial reporting quality. We measure accrual quality using two different measures, that is Q_1 and AQ_2. We report the estimated results for our baseline difference-in-differences (DiD) regression in columns 1 and 2, respectively of Table 3. Columns 1 and 2 show that the coefficients on *FOR*POST* are negative and significant at the 1% and 5% levels, respectively. Given that the lower values of AQ_1 and AQ_2 imply higher accrual quality, the significantly negative coefficients on *FOR*POST* in columns 1 and 2 (with AQ_1 and AQ_2, respectively, as *DV*) can be interpreted in such a way that an improvement in accrual quality for firms with foreign investors from the pre- to the post-period are significantly greater, compared with the improvement for firms without foreign investors for the same period. Stated another way, foreign investors play a significant role in improving financial reporting of local firms in which they invest.

[Insert Table 3 here]

3.3. The impact of foreign investors' monitoring on corporate governance efficacy

We examine whether and how external monitoring by foreign investors enhance corporate governance efficacy by: (i) lowering the compensation level; (ii) improving the pay-for-performance sensitivity; and (iii) decreasing insider trading profit. To assess the impact of foreign investors' monitoring on the compensation level, we estimate Eq. (5) with the compensation level (*COMP*) as *DV* in column 3 of Table 3.

As shown in column 3, we find that the coefficient on the key variable of our interest, i.e., *FOR*POST* is negative and significant at the 10% level (-0.226 with t = -1.860). This finding is consistent with our prediction, suggesting that the compensation level decrease for firms with foreign investors from the pre to the post period, compared with the change in compensation for firms with no foreign investors for the same period.

We now investigate whether and how external monitoring by foreign investors influence the pay-for-performance sensitivity. To this end, we estimate an augmented version of our DiD regression with *DV* = *COMP* as specified below:

$$DV_{it} = \alpha_0 + \alpha_1 FOR_{it} + \alpha_2 POST_{it} + \alpha_3 FOR_{it}*POST_{it} + \alpha_3 ROA_{it} + \alpha_3 ROA_{it-1}$$

$$+ \ \alpha_3 ROA_{it}*FOR_{it} + \alpha_3 ROA_{it}*POST_{it} + \alpha_3 ROA_{it}*FOR*POST_{it} \quad\quad\quad (6)$$

$$+ \ (Controls) + (error),$$

where the variables are as defined earlier.

To the extent that foreign investors play the role of external monitoring, we predict that the executive pay or compensation level (*COMP*) should become more sensitive to performance (proxied by *ROA*) for firms with foreign investors from the pre-period (before the entrance of foreign investors) in the post-period (after the entrance of foreign investors), compared with firms with no foreign investors for the same period. This prediction translates into $\alpha_3 > 0$ in our augmented DiD regression in Eq. (6). As shown in column 4 of Table 3, we find that the coefficient on *ROA*FOR*POST*, i.e., α_3, in Eq. (6) is positive and significant at the 5% level (6.409 with t = 2.231). This improvement in the pay-for-performance sensitivity implies that foreign investors play a significant role in monitoring the performance of local firms.

Finally, we examine whether external monitoring by foreign investors leads to a decrease in insider trading profit measured by cumulative abnormal returns for the 120-day post-trading period, denoted by *CAR(1, 120)*. To this end, we estimate Eq. (5) with *CAR(1, 120)= DV*. To the extent that foreign investors' monitoring reduce the amount of inside trading profit, we predict that insider trading profit should decrease from the pre-period to the post-period for firms with foreign investors, compared with that for the same period for firms with no foreign investors. This prediction is supported if we observe the coefficient on FOR*POST is negative in our DiD regression as specified in column 5 of Table 3. As shown in in column 5, we find that this coefficient is negative and significant at the 10% level (-0.156, t = -1.749).

In short, the results of our baseline DiD regressions presented in Table 3, taken together, is in line with the view that the entrance of foreign investors into China's stock market improve their monitoring, which, in turns, enhances not only financial reporting quality, captured by accrual quality of local firms, but also their corporate governance efficacy, captured by the level of compensation, the pay-for-performance sensitivity, and inside trading profit.

4. Institutional Distance and Financial Reporting Quality of Local Firms

Section 3 reveals that foreign investors help to improve both financial reporting quality and governance efficacy of local firms. We argue, however, that the monitoring effectiveness of foreign investors could be constrained by the institutional distance between the home and host countries of foreign investors. That is, the monitoring effect is not uniform across local firms. We expect it to be stronger (weaker) among firms with foreign investors that are more (less) familiar with the institutional background of the host country. In this section, we focus on firms with foreign investors, and examine their monitoring effect in terms of the improvement of local firms' financial reporting quality.

4.1. Impact of institutional distance on foreign investors' monitoring of financial reporting quality

In Panel A of Table 4, we split sample firms with foreign investors into two groups based on whether the formal institutional distance between the home countries of foreign investors and China is above or below the sample median. Both AQ_1 and AQ_2 are significantly higher (lower) when *ID* is longer (shorter), rendering support to our hypothesis that formal institutional distance has a negative impact on the financial reporting quality. We also compare other firm characteristics of the two groups in the following rows of the panel. The two groups are similar in terms of size, leverage ratio, profitability, and book-to-market ratio. However, firms in the group with longer formal institutional distance tend to have lower shareholder concentration.

We repeat the analysis but focus on the impact of informal institutional distance in Panel B of Table 4. The results are similar. The average AQ_1 and AQ_2 of the group with longer informal institutional distance are about 20% higher than those of the group with shorter informal institutional distance, and the difference is significantly positive at the 1% level. The results in Table 4 confirm that both the formal and informal institutional distances are negatively related to the financial reporting quality of local firms, which could result from the fact that foreign investors could not play their monitoring role effectively when it is difficult for them to understand the institutional background of the local firms.

We further examine the relation between institutional distance and local firms' financial reporting quality using panel regressions. We estimate the following regression that examines the impact of institutional distance, captured by *ID* and *CD*, on the monitoring effectiveness of foreign investors:

$$DV_{it} = \alpha_0 + \alpha_1 ID_{it} + \alpha_2 CD_{it} + (Controls) + (error). \tag{7}$$

The variables are as defined earlier. The coefficients on ID_{it} and CD_{it} measure the impact of formal and informal institutional distance, respectively, on DV_{it}, which refers to financial reporting quality or corporate governance efficacy.

In columns 1 and 3 of Table 5, we regress AQ_1 and AQ_2, respectively, on *ID* and *CD* with the control of firm characteristics. The coefficients on *ID* and *CD* are both significantly positive, which is consistent with the evidence in Table 4 and confirms that institutional distance is negatively related to local firms' financial reporting quality. Moreover, the evidence that the coefficients on both *ID* and *CD* are significant when we regress accruals quality on them simultaneously suggests that each measure conveys unique information on institutional distance and that their information content is not exchangeable.

Our results may suffer from measurement errors in constructing the institutional distance variables. Thus, we use Corruption Perceptions Index (CPI) difference and legal origin difference as instruments for formal institutional distance. Following Guiso, Sapienza, and Zingales (2009) and Ahern et al. (2012), we use genetic distance as instruments for informal institutional distance. We then perform the two stage OLS regressions for formal and informal institutional distance respectively. At the first stage, we estimate regressions where the dependent variables are formal and informal institutional distance and report the results in Table A-2 in the appendix. We then repeat the analysis above using predicted formal and informal institutional distances from the first stage as our instrumental variables. We present the results obtained using the IV approach in columns 2 and 4, and they are similar to those reported in columns 1 and 3.

We further investigate the impact of institutional distance on local firms' financial reporting quality in terms of management's disclosure behavior. We use management's voluntary forecast disclosure propensity (*VFD*) and management forecast error (*MFE*) as the dependent variable in Eq. (8). Columns 5 to 8 of Table 5 present the results. In columns 5 and 6, the coefficients on both *ID* and *CD* are significantly negative, indicating that for firms with foreign investors from countries that are more distant from China in terms of institutional background, managers are less likely to make voluntary management earnings forecast. Columns 7 and 8 further show that formal and informal institutional distance are both significantly positively associated with management forecast error, suggesting that the accuracy of management forecast decreases with the institutional distance between the home countries of foreign investors and China. The results are consistent with our conjecture that the institutional distance between home and host countries of foreign investors adversely affect their monitoring effectiveness, thus is associated with lower financial reporting quality of local firms.

4.2. The influence of board director appointment

Prior studies show that foreign investors could enhance their monitoring effect through appointing foreign directors on the boards of local firms (e.g., Choi, Park, and Yoo, 2007). A foreign director appointed to the board would oversee the firm's operation as well as financial information production more closely. We further conjecture that appointing directors on the boards of local firms may help foreign investors to become more familiar with firms' regular operations, Chinese accounting standards and rules, laws and regulations, governance practices, management styles, and alike. Thus foreign investors may exploit to eliminate the negative effect of institutional distance through board director appointment.

In Table 6, we include interaction terms between board director appointment and institutional distance into the regressions. When accruals quality are examined in the first four columns, the coefficients are significantly negative on $ID \cdot Board$ but indistinguishable from zero on $CD \cdot Board$. It suggests that director appointment by foreign investors can help to reduce the negative impact of formal institutional

distance, but not that of informal institutional distance.

[Insert Table 6 here]

In columns 5 to 8, where management disclosure behavior is examined, the results are similar. Both the negative relation between formal institutional distance and management forecast propensity and the positive relation between formal institutional distance is weakened if foreign investors appoint directors on the boards of local firms. The coefficients on the interaction terms between informal institutional distance and board director appointment, however, are indistinguishable from zero. Overall, the results show that foreign investors could reduce the negative impact of formal institutional distance by appointing directors the boards of local firms. However, the impact brought by informal institutional distance, which mainly origins from culture differences, is difficult to overcome.

5. Institutional Distance and Corporate Governance Efficacy of Local Firms

To investigate the influence of institutional distance on local firms' governance, we explore whether institutional distance is correlated with ineffective management compensation incentive. Besides, we examine the profits obtained from trading stock of the local firm by corporate insiders. We expect insiders to profit more from trading on inside information when the institutional distance is long and the monitoring effect of foreign investors is weak. This complements previous evidence on local firms' financial reporting quality.

5.1. Executive compensation and pay-for-performance sensitivity

To the extent that lax monitoring by foreign investors with long institutional distance contributes to poor governance, we expect executive compensation to be high and   pay-for-performance sensitivity to be low in these cases. Table 7 presents the results. In Panel A, we regress executive compensation on *ID* and *CD*. The coefficients on *ID* and *CD* are both positive and significant in column (1), and the results are similar under the IV approach in column 2. The coefficients on $ID \cdot Board$ in columns 3 and 4 are both significantly negative, suggesting that foreign investors could mitigate the influence of institutional distance on executive compensation

through appointing directors on the boards of local firms. The coefficient on $CD \cdot Board$, again, is indistinguishable from zero.

[Insert Table 7 here]

Panel B of Table 7 reports the results for executive pay-for-performance sensitivity. We regress executive compensation on institutional distance measures, ROA, as well as the interaction terms between institutional distance and ROA. The coefficients on $ID \cdot ROA$ and $CD \cdot ROA$ in columns 1 and 2 are both significantly negative, indicating that executive compensation is less sensitive to firm performance when the foreign investors are coming from countries that are more distant from China in terms of institutional background. In columns 3 and 4, we examine the influence of appointing directors on the boards of local firms through examining the coefficients on $ID \cdot ROA \cdot Board$ and $CD \cdot ROA \cdot Board$. The coefficient is significantly negative on $ID \cdot ROA \cdot Board$, but indistinguishable from zero on $CD \cdot ROA \cdot Board$, suggesting that director appointment can only mitigate the negative effect of formal institutional distance but not that of informal institutional distance.

5.2. Trading profit of insiders of local firms

Past studies ((e.g., Jagolinzer, Larcker, and Taylor , 2011; Skaife, Veenman, and Wangerin, 2013; Jerry, Parwada, and Zhang, 2015) document that insider trading profit is higher when corporate governance is weaker, and that effective external monitoring could mitigate trading on inside information. Hence, we expect that when foreign investors are from countries that are more institutionally distant to China, the trading of the stock of the local firm is more profitable for corporate insiders as they are less effectively monitored and are more likely to trade on inside information.

We examine profit of trading by insiders of the local firms in Table 8. We use the abnormal return of the local firm's stock over a 120-day period after the trading date to measure the profit of insiders. The profit is significantly positively associated with both *ID* and *CD*. This result suggests that, as foreign investors from countries that are more institutionally distant to China are less effective in monitoring insiders of the local firms, who could therefore benefit more from trading on inside information. In columns 3 and 4, the coefficients are both negative on the interaction

terms $ID \cdot Board$ and $CD \cdot Board$ (though not significant on the latter one), indicating that foreign investors could moderate the negative effect of institutional distances on insider trading through appointing directors on the boards of local firms.

[Insert Table 8 here]

6. The Exogenous Impact of the Enforcement of New Chinese Accounting Standards

One important concern of our investigation is that the relation between institutional distance and local firms' financial reporting quality and governance is endogenous. As institutional distance increases the informational disadvantage of foreign investors, it is possible that investors from countries more distant from China fail to identify and invest in local firms with better financial reporting quality and governance practices. To address this concern, we examine change in the relation between foreign investors' monitoring effectiveness and institutional distance around China's adoption of new accounting standards in 2007.

On 15 February 2006, China's Ministry of Finance issued a set of new Chinese Accounting Standards that are substantially in line with IFRS and will come into effect on 1 January 2007. Listed companies must adequately prepare themselves for the adoption of these new standards that will bring significant changes to their existing financial reporting and corporate accounting system. This reform provides an exogenous shock to the institutional distance, especially the formal institutional distance, between foreign countries and China. The new Chinese standards that incorporate accounting principles familiar to investors from IFRS countries are expected to reduce the formal institutional distance between IFRS countries and China. IFRS countries are those that have mandated IFRS before 2007, including Australia, Austria, Belgium, Denmark, France, Germany, Hong Kong, Netherlands, Singapore, Switzerland, and UK. After the 2007 reform, we expect the negative impact of formal institutional distance to be weakened for firms with foreign investors from IFRS countries, but not for firms with foreign investors from non-IFRS countries.

We add a dummy variable, *PostREG*, into the baseline regressions. *PostREG* equals one after the enforcement of new accounting standards, and zero otherwise. The results are shown in Table 10.[6] Columns 1 to 4 report the results for local firms with foreign investors from IFRS countries, and columns 5 to 8 present the results for local firms with foreign investors from non-IFRS countries. For the IFRS countries group, the enforcement of new Chinese Accounting Standards significantly reduce the negative impact of formal institutional distance on financial reporting quality and governance, but has limited influence on the impact of informal institutional distance. It is as expected as the convergence between Chinese Accounting Standards and IFRS only works to reduce the formal institutional distance, but not the informal institutional distance.

[Insert Table 9 here]

In comparison, among the non-IFRS countries, the enforcement of new Chinese Accounting Standards has little effect on the relation between institutional distance and the financial reporting quality and governance efficacy of local firms, consistent with our expectation. The results provide support to our hypothesis that institutional distance affects the monitoring effect of foreign investors, and that the results are mainly driven by foreignness rather than endogenous issues.

7. Robustness Checks

7.1 Institutional distance and the change in local firms' financial reporting quality and governance efficacy

We focus on the level of financial reporting quality and governance efficacy of local firms in previous tests. We now switch to focus on the *change* in local firms' financial reporting quality and governance efficacy after the entrance of foreign investors, and examine its relation with institutional distance.[7] The results are

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[6] We obtain 399 and 591 observations in the pre- and post-new Chinese Accounting Standards period respectively, but only 9 observations with voluntary management forecast data, and 18 observations with transactions by insiders in pre- new Chinese Accounting Standards period. We thus drop the analysis of voluntary management forecast disclosure, management forecast error, insider trading profits in this robustness check.

[4] We obtain 243 and 242 sample firms in the pre- and post-period respectively, but only less than 20 firms have voluntary management forecast data in both pre- and post-periods. We thus drop the analysis of voluntary

reported in Table 10.

[Insert Table 10 here]

A dummy variable *Post* is included in the regressions, which equals one if foreign investors have entered the local firms, and zero otherwise. The coefficients on $ID \cdot Post$ and $CD \cdot Post$ are both significantly positive in columns 1 and 2, suggesting that after the entrance of foreign investors, greater institutional distance is associated with a larger decrease in local firms' financial reporting quality.

Columns 3 to 5 examine the change in governance efficacy in terms of executive compensation, executive pay-for-performance sensitivity, and insider trading profit. The coefficients are significantly positive on $ID \cdot Post$ and $CD \cdot Post$ in column 3, significantly negative on $ID \cdot ROA \cdot Post$ and $CD \cdot ROA \cdot Post$ in column 4, and significantly positive on $ID \cdot Post$ and $CD \cdot Post$ in column 5. It suggests that for firms with foreign investors, when the institutional distance is longer, the entrance of foreign investors tends to be followed by higher executive compensation, lower executive pay-for-performance sensitivity, and higher trading profit made by insiders of the local firms.

In sum, Table 10 provides evidence that the *change* in local firms' financial reporting quality and governance is also negatively associated with the institutional distance between the home and host countries of foreign investors, further alleviating the concerns about the endogenous issues.

7.2. Institutional distance and local firms' financial reporting quality and governance in the pre-period

We also examine whether local firms' financial reporting quality and governance before the entrance of foreign investors, or during the pre-period, is associated with the formal and informal institutional distances between the home and host countries of foreign investors. Unreported tests reveal that the institutional distance is not associated with local firms' financial reporting quality or governance before the entrance of foreign investors. The results confirm that our main results are not driven by the tendency of foreign investors from countries with an institutional

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management forecast disclosure and management forecast error in this robustness check.

environment more distinct from that of China to invest in firms with poorer financial information quality and governance, but driven by the fact that foreign investors less familiar with the institutional environment of China are less likely to play their monitoring role properly.

7.3. The influence of prior operation or investment experience in China

If the negative impact of institutional distance on the monitoring effect of foreign investors is resulting from the significant liability of foreignness that they are facing in the host countries, such impact should be more or less reduced for foreign investors that have cumulated certain operation or investment experience in China. We divide our sample into two groups based on whether the foreign investors have set up branches in China or invested in other local firms before entering the current local firm. We expect foreign investors to be more familiar with the institutional background of China if they have prior exposures to the Chinese markets, and thus to face fewer difficulties in monitoring the local firms. The results are shown in Table 11.[8]

[Insert Table 11 here]

The results in Panel A of Table 11, where the subsample includes local firms with foreign investors that do not have prior operation or investment experience in China, are similar to those reported in Tables 5 to 8. The institutional distance is negatively related to the quality of financial reporting and governance efficacy. When local firms with foreign investors that have established local branches or invested in other local firms are examined in Panel B, however, the negative impact of both *ID* and *CD* on the monitoring effectiveness of foreign investors disappears. The results suggest that the influence of *ID* and *CD* takes place through foreign investors' unfamiliarity with the institutional background in China. Once they have accumulated operation or investment experience in China, they could overcome the adverse impact of institutional distance.

7.4. Institutional distance measures orthogonalized to the difference in

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[8] In the analysis of voluntary management forecast disclosure and management forecast error, the control variable LOSS is omitted because of collinearity.

country-level governance practices

Literature has shown that governance practices of foreign investors' home countries would affect their monitoring effectiveness in the host country. If countries that are more distant from China in terms of institutional distance tend to have weaker governance practices, we would also find institutional distance to be negatively related to both financial reporting quality and governance of local firms.

To reduce the likelihood that the institutional distance measures are connected to the difference in the governance practices between home and host countries of foreign investors, we form institutional distance measures that are orthogonalized to country-level governance practices differences. We use two measures to capture country level governance gap: *LegalOr* and *AntiSelfDealing*. *LegalOr* is constructed following La Porta, Lopez-de-Silanes, and Shleifer (2002), and measures the difference in the legal regime between the home and host countries of foreign investors. *AntiSelfDealing* captures the country-level difference in the anti-self-dealing index, which is obtained from Djankov, LaPorta, Lopez-de-Silanes, and Shleifer (2008). We regress *ID* and *CD* on *LegalOr* and *AntiSelfDealing*, respectively, and obtain the residuals $ID^\perp$ and $CD^\perp$. Unreported tests reveal that *LegalOr* and *AntiSelfDealing* could only explain around 30% of the variation in *ID*, and 10% of the variation in *CD*, suggesting that much of the information contained in the institutional distance measures could not be explained by the difference in country-level governance between the home and host countries of foreign investors.

We repeat analysis in the previous sections based on $ID^\perp$ and $CD^\perp$ in Table 12. The two measures produce consistent results. Even after removing the governance practice difference between the home and host countries of foreign investors from *ID* and *CD*, the institutional distance measures still indicate that longer (shorter) institutional distance is related with poorer (better) financial reporting quality and governance efficacy of local firms.

[Insert Table 12 here]

7.5 Firms with A-shares only

As aforementioned, Chinese listed firms issue A-shares to domestic investors.

Some firms also issue shares to foreign investors, such as B-shares traded on the Shanghai or Shenzhen stock exchange, and H-shares traded in Hong Kong. Gul, Kim, and Qiu (2010) assert that A-, B-, and H-share markets have different institutional infrastructures, including disclosure regulations and investor protection. Thus firms with only domestic shares and firms with foreign shares are facing different regulation requirements and information environment.[9] To isolate the influence of institutional infrastructures of different markets, we reexamine the impact of institutional distance on local firms' financial reporting quality and governance efficacy in the subsample of firms with A-shares only. The results remain robust, and are reported in Table 13.

[Insert Table 13 here]

8. Institutional Distance and Local Firms' Performance and Valuation

Previous sections show that long institutional distance constrains foreign investors from monitoring managers of local firms effectively. In this section, we examine the economic consequences of such a constraint from two perspectives: local firms' operational performance and market valuation.

We first examine whether longer institutional distance between the home and host countries of foreign investors is less likely to be followed by an improvement in the operational performance of local firms, and vice versa. For each sample firm in year t, we calculate its change in ROA, or ΔROA, relative to its ROA in the year prior to the entrance of foreign investors. If foreign investors entered the firm before it became listed, we calculate ΔROA based on the firm's ROA in the year of IPO. We regress ΔROA on ID and CD, with a set of control variables, in Table 13.

[Insert Table 14 here]

In column (1) of Table 14, the coefficients on both ID and CD are significantly negative at the 5% level, consistent with our expectation. We further include interaction terms between institutional distance measures and the board appointment indicator $Board$ in columns 3 and 4. The coefficient is significantly positive on

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[9] As Gul, Kim, and Qiu (2010) put it, the Shanghai or Shenzhen domestic exchange that is considered an emerging market, while the Hong Kong stock exchange that is a well-developed market..

$ID \cdot Board$ but indistinguishable from zero on $CD \cdot Board$. The results suggest that longer institutional distance, which hinders the monitoring effectiveness of foreign investors, is more likely to be followed by performance deterioration of local firms. However, if foreign investors appoint directors on the boards of local firms, such an adverse effect could be alleviated. But director appointment could only work to reduce the negative influence of formal institutional distance, not that of informal institutional distance. It is consistent with our previous findings that the adverse impact of informal institutional distance on the monitoring role of foreign investors could hardly be attenuated by director appointment.

Past studies also suggest that foreign investors have a significantly positive impact on firm valuation, as measured by Tobin's Q (e.g., Ferreira and Matos, 2008; Aggarwal et al., 2011). We proceed to examine whether such an impact is conditional on the institutional distance between the home and host countries of foreign investors by regressing *TobinQ* on *ID* and *CD*, with a set of control variables. Table 15 reports the results. Columns 1 and 2 show that the coefficients on both *ID* and *CD* are significantly negative, confirming that long institutional distance between the home countries of foreign investors and China has an adverse impact on the valuation of local firms. It is consistent with our expectation that foreign investors with long formal (informal) institutional distance are less capable in exhibiting their positive influence over local firms. In columns 3 and 4, we add interaction terms between the institutional distance measure and *Board* into the regressions. The results suggest board director appointment could alleviate the negative influence of formal institutional distance on local firms' valuation, but not that of informal institutional distance.

[Insert Table 15 here]

The evidence on the negative relation between institutional distance and firm performance and valuation complements our findings in previous sections. The real consequences associated with institutional distance are consistent with its impact on the monitoring effect of foreign investors.

9. Conclusions

In this study, we examine the influence of the institutional distance between the home and host countries of foreign investors on their monitoring effectiveness. We conjecture that long institutional distance makes it difficult for foreign investors to collect information and understand the business environment of local firms, thus reduces the monitoring effectiveness of these investors. We perform investigation on the relation between institutional distance and the quality of local firms' financial reporting quality and corporate governance based on a group of Chinese listed firms, and find supporting evidence. The accruals quality, management's voluntary disclosure frequency, and management earnings forecast accuracy all decrease with the institutional distance between the home countries of foreign investors and China. Besides, long institutional distance is associated with higher executive compensation, lower executive pay-for-performance sensitivity, and higher insider trading profit. We further show that foreign investors could mitigate the negative influence brought by long formal institutional distance by appointing directors on the boards of local firms. However, the board director appointment has little effect in reducing the negative impact induced by long informal institutional distance.

Lastly, we document that long institutional distance between the home and host countries of foreign investors has a negative impact on both subsequent local firms' operational performance and market valuation. This is consistent with the evidence that long institutional distance reduces the monitoring effectiveness of foreign investors and constrains them from taking value-enhancing actions in local firms.

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Appendix

Table A-1 provides the definitions of variables used in the empirical investigation.

Table A-2 reports results for the first stage of 2SLS regressions. We construct instrumental variables for both formal and informal institutional distances respectively. The instrumental variables for formal institutional distance is built based on the differences in the Corruption Perceptions Index (CPI) and legal origin between nations. The CPI ranks countries by their perceived levels of corruption derived from expert assessments and opinion surveys. It is highly correlated with control of corruption, government effectiveness, rule of law, and regulatory quality, the dimensions used in measuring formal institutional distance in this study. Legal origin is an important determinant of financial and economic development, and formal institutional distance is manifested in differences in political rules, legal decisions, and economic issues. The instrumental variable for informal institutional distance is genetic distance, a measure of the probability that two random alleles (DNA variations) from two populations will be different, based on the dominant population of a country, which is used in Guiso et al. (2009) and Ahern et al. (2012) as instrument for specific cultural dimensions including trust and egalitarianism.

Columns (1) and (2) of Table A-2 show that the coefficients on *CPID* and *GeneticD* are both significantly positive at the 1% level. The coefficient on *LegalOr* is also positive, but insignificant. The fact that *LegalOr* is not time variant might weaken its statistical significance. The results are as expected and validate the variables as instruments for institutional distance measures. The Stagier and Stock (1997) *F*-statistic is 205.343 and 760.770 in columns (1) and (2), respectively, suggesting that the instruments do not appear to suffer from weak instrument problem. The two instruments *CPID* and *LegalOr* pass the Sargan *J*-test for over-identifying restrictions, indicating that the null hypothesis that both instruments are exogenous cannot be rejected.

Table A-1. Variable Definitions

Panel A: Earnings quality, foreign institutional holdings, institutional distance, and firm characteristics

Firm-level earnings quality measure

AQ_1	The absolute value of the residual of Dechow and Dichev (2002) model.
AQ_2	The absolute value of the residual of McNichols (2002) model.
ΔNI	The annual change in net income scaled by year-end total assets.
ΔNI	A dummy variable that equals one if ΔNI is negative for this year, and 0 otherwise.

Foreign institutions holding characteristics

OWN_F	Aggregate foreign ownership held by the top ten largest shareholders.
FOR	An indicator variable that equals one if the firm has ever been invested by foreign investors, and zero otherwise.
$Board$	A dummy variable that equals one if a firm's foreign investors appoint at least one director to its board.
$POST$	An indicator variable that equals one for observations after the entrance of foreign investors, and zero otherwise.
CHN_Branch	A dummy variable that equals one if a firm's foreign investors establish local branches or invest in other local firms before entering this firm, and zero otherwise.

Institutional distance

ID	Formal institutional distance between the home country of the firm's foreign investors and China, measured by the scaled square of the difference between two nations' scores on five worldwide governance indicators released by the World Bank annually, as shown in Panel B.
CD	Informal institutional distance between the home country of the firm's foreign investors and China, measured by the scaled square of the difference between two nations' scores on Hofstede's five cultural dimensions, as shown in Panel B.
$CPID$	Difference in Corruption Perceptions Index (CPI) between the home country of the firm's foreign investors and China, measured by the scaled square of the difference in the two nations' scores on CPI published by the Transparency International (TI) annually.
$LEGALOR$	A dummy variable that equals one if the legal system (civil (socialist) law vs. common law) in the home country of a firm's foreign investors is different from that of China, and zero otherwise. Data on nations' legal systems are obtained from La Porta et al. (2002).
$GENETICD$	A measure of the probability that two random alleles (DNA variations) from two populations will be different, based on the dominant population of a nation (Cavalli-Sforza, Menozzi, and Piazza, 1994; Spolaore and Wacziarg, 2009).
$AntiSelf\text{-}Dealing$	Difference in the anti-self dealing index (Djankov et al., 2008) between the home countries of foreign investors and China.

$ID^{\perp}$	Formal institutional distance that is orthogonal to *LegalOr* and *AntiSelfDealing*, measured by the residual from regressing *ID* on *LegalOr* and *AntiSelfDealing*.
$CD^{\perp}$	Informal institutional distance that is orthogonal to *LegalOr* and *AntiSelfDealing*, measured by the residual from regressing *CD* on *LegalOr* and *AntiSelfDealing*.

Firm characteristics	
COMP	Natural logarithm of executive compensation (the sum of the three highest compensations for a firm's executives), measured at the fiscal year end.
VFD	A dummy variable that equals one if the firm voluntarily issues at least one earnings forecast for the current year, and zero otherwise.
MFE	Absolute value of the difference between management earnings forecast and realized earnings, scaled by the absolute value of the realization. Managers' earnings estimate is the point forecast, or the midpoint of a range forecast. When a firm issues more than one forecast for the year, we retain only the first forecast.
CAR(1,120)	Insider trading profit. For purchases, it is measured by the cumulative abnormal returns over a 120-day window beginning on the insider trading date. For sales, it is measured by the cumulative abnormal return multiplied by minus one. To obtain the abnormal returns, we first estimate market beta for the stock using the CAPM model over a 90-day window 30 days before the insider trading date.
LogTA	The natural logarithm of total assets, measured at the fiscal year end.
LogMV	The natural logarithm of the market value of equity measured at the fiscal year end.
BM	The book-to-market ratio measured at the fiscal year end.
LOSS	A dummy variable that equals one if net income is negative for the year, and zero otherwise.
OwnCon	The ownership of the largest shareholder divided by that of the second largest shareholder.
LEV	Total debt divided by total assets, measured at the fiscal year end.
ROA	Net income divided by total assets, measured at the fiscal year end.
PastMonthRet	Return over the prior month.
PastYearRet	Return over the prior year.
TobinQ	Market value of equity plus book value of debt over book value of assets, measured at the fiscal year end.
%InsideTrade	The relative insider trading size as a percentage of total shares.
PostREG	A dummy variable that equals one after the enforcement of new Chinese Accounting Standards, and zero otherwise.

Panel B: Measures of formal and informal institutional distances			
Variables	Components	Source	Variable Construction
Formal institutional distance (*ID*)	Voice and Accountability Government Effectiveness Regulatory Quality Rule of Law Control of Corruption	Worldwide Governance Indicators (WGI)	$ID = \sum_{k=1}^{n} [\frac{(I_{kj} - I_{kc})^2}{VAR_k}]/n$ I_{kj}: k^{th} ID dimension for country j I_{kc}: k^{th} ID dimension for country c VAR_k: variance of kth ID dimension n: number of ID dimensions
Informal institutional distance (*CD*)	Power distance Individualism Masculinity Uncertainty Avoidance Long-term Orientation	Hofstede (2001)	$CD = \sum_{s=1}^{m} [\frac{(I_{sj} - I_{sc})^2}{VAR_s}]/m$ I_{sj}: s^{th} CD dimension for country j I_{sc}: s^{th} CD dimension for country c VAR_s: variance of sth CD dimension m: number of CD dimensions

Table A-2. First stage of 2SLS regressions

This table reports estimates from the first-stage regression of 2SLS. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

	(1) ID	(2) CD
CPID	1.140***	
	(30.222)	
LegalOr	0.001	
	(0.013)	
GeneticD		30.092***
		(71.912)
ID		-0.076***
		(-4.180)
CD	-0.210***	
	(-9.445)	
OwnCon	-0.003	0.003
	(-0.985)	(1.302)
LogTA	-0.001	-0.098***
	(-0.035)	(-3.856)
LEV	0.045	0.229**
	(0.241)	(2.094)
ROA	-0.801	1.120***
	(-1.529)	(3.638)
BM	-0.199*	-0.079
	(-1.850)	(-0.746)
Intercept	2.200***	1.885***
	(4.081)	(5.007)
Year fixed effects	YES	YES
Industry fixed effects	YES	YES
Obs.No.	990	990
Adjusted R^2	0.768	0.900

Table 1: **Sample distribution by year**

This table reports the distribution of sample firms with foreign investors by year. All the variables are defined in Table A-1 in the Appendix.

	Firms with foreign investors		
Year	No. of firms with foreign investors	% of shares held by foreign investors (*OWN_F*)	% of firms with directors appointed by foreign investors (*Board*)
1999	41	16.911	0.659
2000	46	15.997	0.630
2001	41	15.763	0.707
2002	43	14.461	0.651
2003	45	16.068	0.667
2004	52	16.567	0.692
2005	62	17.742	0.694
2006	69	17.059	0.725
2007	85	19.565	0.741
2008	84	20.233	0.738
2009	79	20.391	0.785
2010	101	23.818	0.762
2011	117	23.226	0.761
2012	125	24.871	0.784
Total	990	-	-

Table 2: **Formal and informal institutional distances by country**

This table reports the formal and informal institutional distances between the home countries of foreign investors and China. All the variables are defined in Table A-1 in the Appendix.

Country	No. of firms with foreign investors	*ID*	*CD*	% of shares held by foreign investors (*OWN_F*)	% of firms with directors appointed by foreign investors (*Board*)
Australia	1	6.589	4.435	21.490	0.000
Austria	6	6.272	5.286	2.060	1.000
Belgium	9	5.111	4.665	20.828	1.000
Canada	3	6.693	4.448	34.930	0.667
Denmark	7	8.205	5.342	19.344	0.688
France	26	4.499	3.856	33.642	0.875
Germany	24	5.852	4.050	9.094	0.571
Hong Kong	330	5.731	0.253	17.320	0.731
India	11	0.838	1.205	31.156	0.906
Japan	161	3.695	2.678	14.777	0.673
Korea	19	2.271	2.149	23.381	0.727
Netherlands	7	7.497	4.913	7.350	0.714
New Zealand	11	7.456	4.777	8.654	0.632
Singapore	73	6.513	1.737	17.308	0.571
Switzerland	16	7.158	3.923	30.670	0.000
Taiwan	119	3.037	1.262	36.431	0.616
Thailand	18	0.726	2.153	20.722	0.944
UK	32	6.540	4.586	17.358	0.916
US	112	5.508	4.345	17.643	0.759
Vietnam	5	0.145	0.817	37.500	1.000

Table 3: **The impact of foreign investors' monitoring on financial reporting quality and corporate governance efficacy**

This table examines the impact of foreign investors' monitoring on financial reporting quality and corporate governance efficacy. *FOR* is an indicator variable that equals one if the firm has ever been invested by foreign investors, and zero otherwise. *POST* is an indicator variable that equals one after the entrance of foreign investors, and zero otherwise. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)
	AQ_1	AQ_2	COMP	COMP	CAR(1,120)
FOR	-0.000	0.001	0.129*	0.207**	0.195**
	(-0.037)	(0.182)	(1.677)	(2.463)	(2.476)
POST	0.038***	0.022***	0.673***	0.830***	0.333***
	(4.499)	(2.882)	(5.027)	(5.430)	(7.033)
FOR ⨉ POST	-0.027***	-0.021**	-0.236*	-0.418***	-0.156*
	(-2.780)	(-2.396)	(-1.860)	(-2.665)	(-1.749)
ROA ⨉ POST				-5.799**	
				(-2.306)	
FOR ⨉ ROA				-2.631*	
				(-1.903)	
FOR ⨉ ROA ⨉ POST				6.409**	
				(2.231)	
OwnCon	-0.000	-0.000	-0.000	-0.000	
	(-0.536)	(-0.663)	(-0.738)	(-0.875)	
LogTA	0.001	-0.004	0.614***	0.626***	
	(0.296)	(-1.130)	(10.026)	(9.524)	
LogMV					0.051***
					(2.919)
LEV	0.032*	0.010	0.709***	0.628**	
	(1.720)	(0.621)	(2.979)	(2.449)	
ROA	-0.041*	-0.004	0.124	2.455***	
	(-1.789)	(-0.205)	(0.211)	(2.612)	
BM	-0.041***	-0.051***	-0.047	-0.046	0.001
	(-3.924)	(-4.824)	(-0.335)	(-0.333)	(0.367)
PastMonthRet					-0.308***
					(-2.937)
PastYearRet					0.082***
					(4.565)
%InsideTrade					0.049**
					(2.300)
Intercept	0.073	0.142***	3.244***	3.011***	-0.847***

	(1.237)	(2.810)	(3.266)	(2.917)	(-2.903)
Year fixed effects	YES	YES	YES	YES	NO
Industry fixed effects	YES	YES	YES	YES	NO
Month fixed effects	NO	NO	NO	NO	YES
Obs. No.	1827	1827	1611	1611	1699
Adjusted R^2	0.040	0.020	0.258	0.265	0.077

(1.237)	(2.810)	(3.266)	(2.917)	(-2.903)

Table 4: **Summary statistics**

This table reports the summary statistics of the key variables used in our investigation during the sample period from 1999-2012. Panel A splits the sample firms with foreign investors into two subsamples based on whether the formal institutional distance is above (long) or below (short) the median. Panel B splits the sample firms with foreign investors into two subsamples based on whether the informal institutional distance is above (long) or below (short) the median. ***, **, and * respectively indicate that the difference is statistically significant at 1%, 5%, and 10% levels. All the variables are defined in Table A-1 in the Appendix.

	Panel A: Formal institutional distance and accruals quality					
	Long *ID*		Short *ID*		Difference in mean	Difference in median
	Mean	Median	Mean	Median	*t-stat*	*z-stat*
AQ_1	0.071	0.048	0.064	0.042	1.703[*]	2.038[**]
AQ_2	0.068	0.047	0.060	0.040	1.987[**]	2.129[**]
OwnCon	3.829	1.951	5.485	2.119	-3.017[***]	0.581
LogTA	21.640	21.680	21.540	21.370	1.269	1.269
LEV	0.426	0.439	0.427	0.424	-0.159	0.162
ROA	0.038	0.042	0.043	0.046	-1.387	-1.739[*]
BM	0.479	0.407	0.477	0.393	0.174	0.956
Obs. No.	572		418			
	Panel B: Informal institutional distance and accruals quality					
	Long *CD*		Short *CD*		Difference in mean	Difference in median
	Mean	Median	Mean	Median	*t-stat*	*z-stat*
AQ_1	0.079	0.048	0.065	0.045	2.624[***]	1.808[*]
AQ_2	0.078	0.050	0.061	0.042	3.541[***]	2.726[***]
OwnCon	4.678	1.847	4.487	2.069	0.268	-0.198
LogTA	22.230	22.200	21.430	21.350	8.613[***]	8.002[***]
LEV	0.479	0.503	0.412	0.413	4.467[***]	4.510[***]
ROA	0.043	0.041	0.039	0.044	0.933	-0.342
BM	0.483	0.420	0.477	0.403	0.329	1.001
Obs. No.	212		778			

Table 5: **Regressions of financial reporting quality on formal and informal institutional distance**

This table shows estimates of panel regressions of accruals quality and voluntary forecast disclosure on institutional distance. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS	Logit	Second stage of 2SLS	OLS	Second stage of 2SLS
	AQ_1	AQ_2	AQ_1	AQ_2	VFD	VFD	MFE	MFE
ID	0.003*	0.003*	0.003**	0.003*	-0.164***	-0.202***	0.067***	0.050**
	(1.889)	(1.715)	(1.971)	(1.871)	(-2.699)	(-2.761)	(3.145)	(2.077)
CD	0.004***	0.004**	0.006***	0.006***	-0.113*	-0.107**	0.058**	0.048**
	(2.654)	(2.366)	(3.799)	(3.575)	(-1.750)	(-2.213)	(2.470)	(2.007)
OwnCon	0.001**	0.001**	0.001**	0.001**	-0.051**	-0.052**	0.007	0.005
	(2.478)	(2.488)	(2.387)	(2.393)	(-2.242)	(-2.480)	(0.721)	(0.497)
LogTA	0.003	0.003	0.003	0.003	-0.848***	-0.850***	-0.015	0.005
	(0.751)	(0.749)	(0.850)	(0.840)	(-7.022)	(-5.626)	(-0.345)	(0.101)
LEV	0.014	0.014	0.004	0.004				
	(0.740)	(0.727)	(0.257)	(0.230)				
ROA	-0.203***	-0.202***	-0.167***	-0.167***				
	(-3.598)	(-3.600)	(-3.475)	(-3.496)				
BM	-0.026**	-0.026**	-0.025***	-0.025***	-2.499***	-2.507***	-0.012	0.027
	(-2.548)	(-2.537)	(-2.953)	(-2.939)	(-5.090)	(-7.070)	(-0.042)	(0.096)
LOSS					-4.380***	-4.382***	0.758***	0.761***
					(-4.092)	(-5.340)	(4.837)	(4.861)
Intercept	0.053	0.051	0.034	0.032	15.430***	15.643***	3.623***	3.431***

	(0.922)	(0.892)	(0.730)	(0.687)	(7.910)	(6.282)	(3.859)	(3.447)
Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Industry fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Obs. No.	990	990	990	990	903	903	192	192
Adjusted R^2(Pseudo R^2)	0.082	0.081	0.077	0.075	0.280	0.280	0.258	0.233

Table 6: **The influence of board director appointment**

This table shows estimates of panel regressions of accruals quality and voluntary forecast disclosure on formal and informal institutional distance, with the interactions terms between board director appointment and institutional distance. The dependent variable is AQ_1 in columns 1 and 2, AQ_2 in columns 3 and 4, VFD in columns 5 and 6, and MFE in columns 7 and 8. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS	Logit	Second stage of 2SLS	OLS	Second stage of 2SLS
	AQ_1	AQ_2	AQ_1	AQ_2	VFD	VFD	MFE	MFE
ID	0.009**	0.008*	0.008**	0.009**	-0.368**	-0.610***	0.211***	0.136**
	(2.554)	(1.938)	(2.575)	(2.234)	(-2.330)	(-3.280)	(4.655)	(2.435)
CD	0.006*	0.004	0.008**	0.007**	-0.367	-0.552*	0.039	-0.183**
	(1.719)	(1.140)	(2.499)	(2.032)	(-1.611)	(-1.650)	(0.448)	(-2.008)
Board	0.023	0.013	0.028	0.025	-1.694***	-2.909***	0.616**	0.088
	(1.096)	(0.482)	(1.397)	(1.007)	(-3.162)	(-3.010)	(2.600)	(0.332)
ID Board	-0.009**	-0.008*	-0.008**	-0.008**	0.261**	0.463***	-0.197***	-0.141***
	(-2.402)	(-1.742)	(-2.407)	(-2.058)	(2.545)	(2.598)	(-4.432)	(-2.664)
CD Board	-0.002	0.000	-0.003	-0.001	0.329	0.536	0.049	0.262***
	(-0.516)	(0.084)	(-0.976)	(-0.377)	(1.275)	(1.546)	(0.564)	(2.824)
OwnCon	0.001**	0.001**	0.001**	0.001**	-0.053***	-0.051**	0.003	0.004
	(2.238)	(2.157)	(2.272)	(2.232)	(-2.605)	(-2.278)	(0.384)	(0.519)
LogTA	0.003	0.003	0.003	0.003	-0.896***	-0.905***	-0.002	-0.015
	(0.852)	(0.743)	(0.911)	(0.841)	(-5.006)	(-6.174)	(-0.043)	(-0.325)
LEV	0.006	0.008	-0.003	-0.003				

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	(0.341)	(0.396)	(-0.194)	(-0.177)				
ROA	-0.207***	-0.205***	-0.171***	-0.171***				
	(-3.778)	(-3.769)	(-3.651)	(-3.686)				
BM	-0.033***	-0.033***	-0.031***	-0.031***	-2.998***	-3.091***	-0.203	-0.218
	(-3.220)	(-3.194)	(-3.552)	(-3.520)	(-5.390)	(-4.451)	(-0.779)	(-0.812)
LOSS					-4.533***	-4.598***	0.701***	0.711***
					(-5.375)	(-3.961)	(4.588)	(4.637)
Intercept	0.015	0.025	0.000	0.001	4.520	6.142**	2.353**	3.498***
	(0.251)	(0.424)	(0.005)	(0.027)	(1.524)	(2.166)	(2.178)	(2.939)
Year fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Industry fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Obs. No.	990	990	990	990	903	903	192	192
Adjusted R^2(Pseudo R^2)	0.110	0.106	0.103	0.099	0.319	0.327	0.357	0.308

Table 7: **Executive compensation, pay-for-performance sensitivity, and institutional distance**
Panel A of this table shows estimates of panel regressions of executive compensation on formal and informal institutional distances. Panel B shows estimates of panel regressions of executive compensation on *ROA* and the interaction terms between *ROA* and institutional distance measures. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	Panel A: Executive compensation and institutional distances			
	(1)	(2)	(3)	(4)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS
	COMP	*COMP*	*COMP*	*COMP*
ID	0.056***	0.054***	0.175***	0.156***
	(3.667)	(2.981)	(4.504)	(3.707)
CD	0.089***	0.091***	0.062	0.050
	(4.498)	(4.318)	(1.442)	(1.089)
Board			0.656***	0.502*
			(2.609)	(1.865)
ID Board			-0.158***	-0.140***
			(-3.800)	(-3.079)
CD Board			0.037	0.061
			(0.826)	(1.282)
OwnCon	-0.005	-0.005	-0.005	-0.005
	(-1.177)	(-1.202)	(-1.151)	(-1.309)
LogTA	0.311***	0.311***	0.328***	0.315***
	(9.755)	(9.701)	(10.198)	(9.877)
LEV	0.056	0.053	0.019	0.031
	(0.338)	(0.313)	(0.118)	(0.190)
ROA	0.794	0.786	0.673	0.711
	(1.105)	(1.103)	(0.951)	(1.012)
BM	0.271**	0.269**	0.206*	0.205*
	(2.309)	(2.256)	(1.795)	(1.740)
Intercept	6.739***	6.737***	5.836***	6.098***
	(12.667)	(12.487)	(10.035)	(10.532)
Year fixed effects	YES	YES	YES	YES
Industry fixed effects	YES	YES	YES	YES
Obs. No.	915	915	915	915
Adjusted R^2	0.506	0.503	0.516	0.510

	(1)	(2)	(3)	(4)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS
	COMP	*COMP*	*COMP*	*COMP*
ROA	8.062***	7.376***	13.274***	10.288***
	(5.684)	(4.602)	(3.289)	(4.247)
ID	0.104***	0.091***	0.229***	0.202***
	(5.445)	(4.096)	(5.623)	(5.678)
CD	0.146***	0.156***	0.089*	0.090
	(5.620)	(5.529)	(1.832)	(1.533)
ID ROA	-0.983***	-0.810***	-2.075***	-1.541***
	(-4.014)	(-2.838)	(-3.290)	(-3.671)
CD ROA	-1.550***	-1.600***	-1.530**	-1.551**
	(-4.300)	(-4.327)	(-2.068)	(-2.273)
Board			0.666**	0.488**
			(2.390)	(2.173)
ROA Board			-6.894	-3.810
			(-1.619)	(-1.333)
ID Board			-0.180***	-0.162**
			(-3.979)	(-3.006)
CD Board			0.084	0.104
			(1.496)	(1.538)
ID ROA Board			1.522**	1.038**
			(2.264)	(2.239)
CD ROA Board			-0.202	-0.293
			(-0.239)	(-0.449)
OwnCon	-0.004	-0.004	-0.004	-0.004*
	(-1.158)	(-1.239)	(-1.140)	(-1.945)
LogTA	0.339***	0.338***	0.360***	0.348***
	(10.796)	(10.667)	(11.234)	(12.839)
LEV	-0.109	-0.132	-0.139	-0.162
	(-0.658)	(-0.797)	(-0.867)	(-1.237)
BM	0.264**	0.239**	0.194*	0.156
	(2.329)	(2.065)	(1.749)	(1.205)
Intercept	6.010***	6.086***	5.019***	5.337***
	(11.249)	(11.072)	(8.555)	(14.332)
Year fixed effects	YES	YES	YES	YES
Industry fixed effects	YES	YES	YES	YES
Obs. No.	915	915	915	915
Adjusted R^2	0.533	0.525	0.543	0.534

Panel B: Executive pay-for-performance sensitivity and institutional distances

Table 8: **Insider trading profit and institutional distance**
This table shows estimates of regressions of insider trading profit on formal and informal institutional distance. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS
ID	0.015*	0.014*	0.047***	0.033***
	(1.869)	(1.745)	(3.663)	(2.825)
CD	0.023***	0.016**	0.042***	0.021
	(3.184)	(2.075)	(3.063)	(1.452)
Board			0.355***	0.222***
			(4.069)	(3.174)
ID Board			-0.042***	-0.022*
			(-2.597)	(-1.897)
CD Board			-0.024	-0.003
			(-1.530)	(-0.158)
LogMV	-0.005	0.002	-0.002	0.003
	(-0.389)	(0.125)	(-0.196)	(0.277)
BM	0.000	0.000	0.000	0.000
	(0.592)	(0.995)	(0.279)	(0.919)
PastMonthRet	-0.050	-0.045	-0.097	-0.098
	(-0.538)	(-0.550)	(-1.025)	(-1.208)
PastYearRet	0.081***	0.081***	0.073***	0.076***
	(4.545)	(6.009)	(4.050)	(5.652)
%InsideTrade	0.014	0.013	0.012	0.012
	(0.874)	(0.659)	(0.738)	(0.614)
Intercept	-0.143	-0.219	-0.432**	-0.424**
	(-0.828)	(-1.200)	(-2.249)	(-2.162)
Month fixed effects	YES	YES	YES	YES
Obs. No.	1246	1246	1246	1246
Adjusted R^2	0.055	0.050	0.074	0.066

Table 9: **The influence of the enforcement of new Chinese Accounting Standards in 2007**
This table examines the influence of the enforcement of new Chinese Accounting Standards. IFRS countries are those mandated IFRS before 2007. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	IFRS countries				Non-IFRS countries			
	AQ_1	AQ_2	COMP	COMP	AQ_1	AQ_2	COMP	COMP
ID	0.006	0.003	0.369***	0.501***	0.008	0.006	0.185**	0.204**
	(0.963)	(0.557)	(3.578)	(6.478)	(1.458)	(1.214)	(2.355)	(2.489)
CD	0.002	0.003	-0.083*	-0.087*	-0.007	-0.001	-0.166	-0.121
	(0.528)	(0.780)	(-1.683)	(-1.870)	(-0.666)	(-0.127)	(-1.446)	(-1.069)
PostREG	0.088*	0.075	3.112***	4.179***	-0.048**	-0.036*	0.141	-0.387
	(1.736)	(1.577)	(4.043)	(5.176)	(-2.232)	(-1.805)	(0.572)	(-1.401)
ID·PostREG	-0.017*	-0.013*	-0.386***	-0.565***	0.005	0.007	-0.008	0.114
	(-1.876)	(-1.659)	(-3.098)	(-4.255)	(0.499)	(0.870)	(-0.079)	(1.103)
CD·PostREG	0.001	0.001	0.121**	0.176***	0.008	0.000	0.236*	0.233*
	(0.103)	(0.329)	(2.443)	(3.120)	(0.639)	(0.021)	(1.945)	(1.767)
ID·ROA				-3.905***				-0.549
				(-3.687)				(-0.451)
CD·ROA				-0.252				-2.735*
				(-0.367)				(-1.690)
ROA·PostREG				-31.183***				2.808
				(-2.760)				(0.720)
ID·ROA·PostREG				5.116***				-1.386
				(2.769)				(-1.099)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
CD ROA PostREG				-0.748				1.716
				(-0.870)				(0.980)
OwnCon	0.000	0.000	-0.009**	-0.007	0.001**	0.001**	-0.000	-0.001
	(0.868)	(0.604)	(-2.410)	(-1.464)	(2.330)	(2.374)	(-0.043)	(-0.156)
LogTA	-0.007	-0.002	0.328***	0.360***	0.014**	0.010**	0.328***	0.349***
	(-1.592)	(-0.519)	(6.675)	(7.320)	(2.475)	(2.001)	(7.341)	(7.576)
LEV	0.031	0.016	0.396	0.207	-0.014	-0.013	-0.258	-0.315
	(1.095)	(0.641)	(1.576)	(0.762)	(-0.490)	(-0.551)	(-1.046)	(-1.312)
ROA	-0.137*	-0.098*	1.070	25.292***	-0.230***	-0.205***	0.453	7.817**
	(-1.933)	(-1.679)	(1.174)	(4.076)	(-2.667)	(-2.850)	(0.355)	(2.234)
BM	-0.032***	-0.020**	0.727***	0.751***	-0.022	-0.024*	0.619***	0.720***
	(-2.684)	(-1.977)	(4.599)	(5.781)	(-1.374)	(-1.680)	(4.668)	(5.356)
Intercept	0.184**	0.089	5.709***	4.456***	-0.195**	-0.148*	5.843***	5.419***
	(2.341)	(1.370)	(5.971)	(4.248)	(-2.142)	(-1.815)	(8.188)	(7.151)
Industry fixed effects	YES	YES	YES	YES	YES	YES	YES	YES
Obs. No.	531	531	491	491	459	459	424	424
Adjusted R^2	0.042	0.030	0.521	0.541	0.105	0.101	0.460	0.510

Table 10: **Robustness check: Institutional distance and the change in financial reporting quality and corporate governance efficacy**
This table examines the change in local firms' financial reporting quality and corporate governance efficacy after the entrance of foreign investors. *POST* is an indicator variable that equals one for observations after the first-time entrance of foreign investors, and zero otherwise. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)	(5)
	AQ_1	AQ_2	COMP	COMP	CAR(1,120)
ID	-0.014**	-0.009*	-0.057	-0.150***	-0.142*
	(-2.451)	(-1.923)	(-1.237)	(-2.962)	(-1.959)
CD	-0.005	-0.004	0.015	0.089**	-0.128**
	(-1.340)	(-1.414)	(0.424)	(2.177)	(-2.476)
POST	-0.103***	-0.082**	-0.754***	-1.088***	-1.748***
	(-2.711)	(-2.484)	(-2.594)	(-3.255)	(-3.742)
ID POST	0.013**	0.008*	0.156***	0.212***	0.270***
	(2.113)	(1.659)	(3.100)	(3.883)	(3.302)
CD POST	0.014***	0.012***	0.099*	0.140**	0.173***
	(3.279)	(3.257)	(1.885)	(2.411)	(3.164)
ID ROA				1.278	
				(1.543)	
CD ROA				0.620	
				(1.386)	
ROA POST				12.693**	
				(2.399)	
ID ROA POST				-1.503*	
				(-1.755)	
CD ROA POST				-1.970***	
				(-3.079)	
OwnCon	-0.000	-0.000	-0.001	-0.001*	
	(-0.759)	(-0.126)	(-1.489)	(-1.682)	
LogTA	0.006	0.007	0.524***	0.538***	
	(1.039)	(1.429)	(8.244)	(9.299)	
LogMV					0.186***
					(5.167)
LEV	0.035	0.041**	0.045	-0.298	
	(1.569)	(1.979)	(0.172)	(-1.109)	
ROA	-0.047***	-0.020*	0.084	-9.012*	
	(-3.143)	(-1.672)	(0.368)	(-1.747)	
BM	-0.033**	-0.028**	0.397***	0.477***	-0.004
	(-2.209)	(-1.966)	(2.779)	(3.654)	(-0.670)
PastMonthRet					0.228

					(1.197)
PastYearRet					0.026
					(0.895)
%InsideTrade					0.008
					(0.102)
Intercept	0.083	0.043	4.333***	3.751***	-2.088***
	(0.852)	(0.487)	(3.765)	(4.189)	(-3.291)
Year fixed effects	YES	YES	YES	YES	NO
Industry fixed effects	YES	YES	YES	YES	NO
Month fixed effects	NO	NO	NO	NO	YES
Obs. No.	483	483	417	417	405
Adjusted R^2	0.100	0.093	0.630	0.649	0.183

Table 11: **Robustness check: The influence of prior operating or investing experience**

This table shows estimates of panel regressions of financial reporting quality and corporate governance efficacy on formal and informal institutional distance, conditional on whether the foreign investors have prior operating or investing experience in China. *CHN_Branch* is a dummy variable that equals one if a firm's foreign investors have established local branches or invested in other local firms before entering this firm, and zero otherwise. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

Panel A: Institutional distance and financial reporting quality and governance (*CHN_Branch*=0)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	AQ_1	AQ_2	VFD	MFE	COMP	COMP	CAR(1,120)
ID	0.003**	0.003**	-0.165***	0.063**	0.050***	0.105***	0.024***
	(2.166)	(2.291)	(-2.614)	(2.445)	(3.147)	(5.080)	(2.843)
CD	0.003*	0.005***	-0.171**	0.046	0.128***	0.179***	0.017*
	(1.829)	(2.943)	(-2.161)	(1.636)	(5.396)	(6.563)	(1.904)
ID·ROA						-1.101***	
						(-4.122)	
CD·ROA						-1.523***	
						(-4.258)	
OwnCon	0.000	0.000	-0.057**	0.010	-0.018***	-0.017***	
	(0.346)	(0.465)	(-1.963)	(1.002)	(-3.426)	(-3.346)	
LogTA	0.004	0.004	-0.755***	-0.135***	0.339***	0.368***	
	(0.985)	(1.381)	(-5.492)	(-2.862)	(8.279)	(9.650)	
LogMV							-0.000
							(-0.008)
LEV	0.009	-0.011			-0.084	-0.241	
	(0.410)	(-0.581)			(-0.436)	(-1.320)	
ROA	-0.224***	-0.200***			1.586**	8.988***	
	(-3.130)	(-3.364)			(2.050)	(5.890)	

BM	-0.026***	-0.025***	-2.159***	0.132	0.375***	0.386***	0.000
	(-2.601)	(-2.978)	(-5.145)	(0.748)	(3.229)	(3.577)	(0.807)
PastMonthRet							0.069
							(0.641)
PastYearRet							0.060***
							(2.728)
%InsideTrade							0.020
							(1.079)
Intercept	-0.000	-0.020	13.588***	4.953***	2.816***	2.448***	-0.200
	(-0.007)	(-0.431)	(6.375)	(7.163)	(4.030)	(3.668)	(-0.765)
Year fixed effects	YES	YES	YES	YES	YES	YES	NO
Month fixed effects	NO	NO	NO	NO	NO	NO	YES
Industry fixed effects	YES	YES	YES	YES	YES	YES	NO
Obs. No.	716	716	648	155	660	660	903
Adjusted R^2(Pseudo R^2)	0.102	0.102	0.196	0.376	0.575	0.602	0.064

Panel B: Institutional distance and financial reporting quality and governance (*CHN_Branch*=1)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	AQ_1	AQ_2	*VFD*	*MFE*	*COMP*	*COMP*	*CAR*(1,120)
ID	-0.004	-0.004	-0.150	0.278	0.012	-0.005	-0.022
	(-1.328)	(-1.280)	(-0.896)	(1.281)	(0.227)	(-0.078)	(-0.616)
CD	0.004	0.004	0.121	0.090	-0.081**	-0.034	0.030
	(1.261)	(1.473)	(0.973)	(1.090)	(-2.117)	(-0.634)	(1.487)
ID ·ROA						-0.299	
						(-0.287)	
CD ·ROA						-1.134	

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
							(-1.605)
OwnCon	0.001	0.001	-0.035	0.264	0.002	0.002	
	(1.504)	(1.467)	(-1.135)	(1.309)	(0.458)	(0.587)	
LogTA	0.004	-0.000	-0.323	0.291	0.307***	0.337***	
	(0.463)	(-0.009)	(-1.612)	(1.294)	(4.352)	(4.503)	
LogMV							-0.008
							(-0.463)
LEV	0.023	0.051			0.246	0.132	
	(0.620)	(1.605)			(0.644)	(0.330)	
ROA	-0.203**	-0.133			-1.507	2.503	
	(-2.066)	(-1.636)			(-0.841)	(0.400)	
BM	-0.020	-0.013	-0.615	0.790	-0.125	-0.177	0.000
	(-0.701)	(-0.551)	(-0.623)	(0.643)	(-0.518)	(-0.716)	(0.711)
PastMonthRet							-0.200
							(-1.119)
PastYearRet							0.135***
							(4.404)
%InsideTrade							0.001
							(0.017)
Intercept	0.064	0.084	5.774*	-19.874	7.635***	7.219***	-0.027
	(0.498)	(0.713)	(1.673)	(-1.492)	(6.731)	(5.785)	(-0.081)
Year fixed effects	YES	YES	YES	YES	YES	YES	NO
Month fixed effects	NO	NO	NO	NO	NO	NO	YES
Industry fixed effects	YES	YES	YES	YES	YES	YES	NO
Obs. No.	274	274	255	37	255	255	343
Adjusted R^2(Pseudo R^2)	0.070	0.070	0.161	0.339	0.424	0.431	0.138

Table 12: **Robustness check: Financial reporting quality, corporate governance efficacy and institutional distance orthogonal to country level governance**
This table examines the relation between financial reporting quality, corporate governance efficacy and formal and informal institutional distance. $ID^{\perp}$ and $CD^{\perp}$ are formal and informal institutional distance measures orthogonal to the country level governance of foreign investors' home countries, respectively. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(4)	(5)	(6)	(7)	(8)
	AQ_1	AQ_2	VFD	MFE	COMP	COMP	CAR(1,120)
$ID^{\perp}$	0.003*	0.004**	-0.183***	0.113***	0.039**	0.087***	0.012*
	(1.796)	(2.141)	(-3.212)	(2.988)	(1.997)	(3.486)	(1.847)
$CD^{\perp}$	0.004**	0.006***	-0.089**	0.060**	0.109***	0.162***	0.028***
	(2.375)	(3.486)	(-2.270)	(2.349)	(5.109)	(5.715)	(3.216)
$ID^{\perp} \cdot ROA$						-1.185***	
						(-3.278)	
$CD^{\perp} \cdot ROA$						-1.542***	
						(-3.975)	
OwnCon	0.001**	0.001**	-0.051**	0.008	-0.005	-0.004	
	(2.482)	(2.426)	(-2.552)	(0.831)	(-1.249)	(-1.285)	
LogTA	0.003	0.003	-0.870***	-0.011	0.306***	0.340***	
	(0.801)	(0.901)	(-5.480)	(-0.253)	(9.554)	(10.787)	
LogMV							-0.007
							(-0.541)
LEV	0.013	0.003			0.054	-0.133	
	(0.674)	(0.196)			(0.321)	(-0.797)	
ROA	-0.199***	-0.164***			0.674	-0.127	
	(-3.502)	(-3.399)			(0.938)	(-0.188)	
BM	-0.024**	-0.023***	-2.515***	0.070	0.276**	0.258**	0.000

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	(-2.401)	(-2.695)	(-6.815)	(0.243)	(2.291)	(2.236)	(0.790)
LOSS			-4.394***	0.701***			
			(-5.285)	(4.301)			
PastMonthRet							-0.054
							(-0.673)
PastYearRet							0.083***
							(6.182)
%InsideTrade							0.013
							(0.629)
Intercept	0.067	0.050	14.705***	3.961***	7.255***	6.821***	-0.047
	(1.159)	(1.043)	(5.855)	(4.280)	(13.526)	(12.951)	(-0.245)
Year fixed effects	YES	YES	YES	YES	YES	YES	NO
Industry fixed effects	YES	YES	YES	YES	YES	YES	NO
Month fixed effects	NO	NO	NO	NO	NO	NO	YES
Obs. No.	985	985	898	188	910	910	1244
Adjusted R^2	0.084	0.083	0.276	0.259	0.509	0.532	0.056

Table 13: **Robustness check: Firms with A-shares only**

This table examines the relation between financial reporting quality, corporate governance efficacy and formal and informal institutional distance for firms with A-shares only. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(4)	(5)	(6)	(7)	(8)
	AQ_1	AQ_2	VFD	MFE	COMP	COMP	CAR(1,120)
ID	0.003*	0.003*	-0.164**	0.067***	0.040**	0.090***	0.028***
	(1.655)	(1.815)	(-2.526)	(3.163)	(2.257)	(4.175)	(3.139)
CD	0.006***	0.006***	-0.112***	0.059**	0.130***	0.195***	0.033***
	(3.014)	(3.632)	(-2.852)	(2.489)	(5.877)	(7.246)	(3.948)
ID·ROA						-1.143***	
						(-4.011)	
CD·ROA						-1.879***	
						(-5.021)	
OwnCon	0.001*	0.001*	-0.075***	0.006	-0.013***	-0.011***	
	(1.911)	(1.714)	(-4.134)	(0.647)	(-3.625)	(-3.153)	
LogTA	0.007	0.007*	-0.795***	-0.020	0.348***	0.370***	
	(1.467)	(1.724)	(-6.300)	(-0.431)	(9.046)	(10.109)	
LogMV							-0.017
							(-1.328)
LEV	-0.015	-0.022			-0.042	-0.242	
	(-0.584)	(-1.101)			(-0.225)	(-1.372)	
ROA	-0.237***	-0.179***			0.839	9.162***	
	(-3.348)	(-3.052)			(1.103)	(5.858)	
BM	-0.027**	-0.008	-1.734***	-0.042	0.359***	0.352***	-0.001**
	(-2.259)	(-0.827)	(-7.620)	(-0.136)	(2.693)	(2.944)	(-2.512)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
LOSS			-3.918***	0.752***			
			(-4.293)	(4.683)			
PastMonthRet							0.135
							(1.402)
PastYearRet							0.025
							(1.277)
%InsideTrade							0.010
							(0.566)
Intercept	0.012	-0.012	14.445***	0.585	6.181***	5.501***	0.088
	(0.161)	(-0.195)	(6.666)	(0.622)	(8.536)	(7.874)	(0.480)
Year fixed effects	YES	YES	YES	YES	YES	YES	NO
Industry fixed effects	YES	YES	YES	YES	YES	YES	NO
Month fixed effects	NO	NO	NO	NO	NO	NO	YES
Obs. No.	709	709	672	190	679	679	973
Adjusted R^2	0.086	0.077	0.221	0.261	0.523	0.561	0.062

Table 14: **Institutional distance and firm performance**

This table shows estimates of panel regressions of the change in firm performance, or ΔROA on formal and informal institutional distance. ΔROA is defined as ROA in year t minus ROA in the year prior to the entrance of foreign investors if foreign investors enter the local firm after its IPO, and minus ROA in the IPO year if foreign investors enter the local firm before its IPO. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS
ID	-0.006***	-0.005**	-0.013***	-0.009***
	(-2.815)	(-2.200)	(-3.007)	(-2.836)
CD	-0.004*	-0.004*	-0.008**	-0.003
	(-1.793)	(-1.791)	(-2.141)	(-0.778)
Board			-0.047*	0.020
			(-1.682)	(1.546)
ID Board			0.010**	0.008**
			(2.085)	(2.155)
CD Board			0.005	-0.002
			(1.119)	(-0.346)
OwnCon	0.002***	0.002***	0.002***	0.002***
	(3.362)	(3.405)	(3.350)	(3.652)
LogTA	0.025***	0.025***	0.025***	0.024***
	(6.067)	(6.052)	(5.940)	(5.962)
LEV	-0.023	-0.024	-0.017	-0.019
	(-0.997)	(-1.004)	(-0.740)	(-0.774)
BM	-0.022*	-0.022*	-0.017	-0.014
	(-1.815)	(-1.812)	(-1.380)	(-1.157)
Intercept	-0.536***	-0.538***	-0.495***	-0.521***
	(-6.426)	(-6.417)	(-5.647)	(-6.159)
Year fixed effects	YES	YES	YES	YES
Industry fixed effects	YES	YES	YES	YES
Obs. No.	990	990	990	990
Adjusted R^2	0.106	0.103	0.112	0.106

Table 15: **Institutional distance and firm valuation**
This table shows estimates of panel regressions of Tobin's Q on formal and informal institutional distance. All variables are defined in Table A-1 in the Appendix. Heterogeneity robust t-statistics are reported in the parentheses. *, **, and *** represent significance at 10%, 5%, and 1% level, respectively.

	(1)	(2)	(3)	(4)
	OLS	Second stage of 2SLS	OLS	Second stage of 2SLS
	TobinQ	*TobinQ*	*TobinQ*	*TobinQ*
ID	-0.059**	-0.060**	-0.230**	-0.217**
	(-1.973)	(-1.990)	(-2.573)	(-2.231)
CD	-0.083***	-0.052*	-0.090*	-0.071
	(-3.092)	(-1.815)	(-1.850)	(-1.338)
Board			-1.167**	-1.254**
			(-1.978)	(-2.035)
ID Board			0.222**	0.239**
			(2.344)	(2.336)
CD Board			0.011	0.015
			(0.192)	(0.264)
OwnCon	0.018***	0.017***	0.016***	0.016***
	(3.026)	(3.000)	(2.606)	(2.655)
LogMV	0.284***	0.278***	0.262***	0.270***
	(4.932)	(4.814)	(4.529)	(4.683)
LEV	-2.477***	-2.528***	-2.413***	-2.476***
	(-8.665)	(-8.793)	(-8.305)	(-8.440)
ROA	-1.205	-1.282	-1.022	-1.094
	(-0.987)	(-1.051)	(-0.863)	(-0.923)
Intercept	-1.193	-1.095	0.088	-0.061
	(-1.374)	(-1.249)	(0.087)	(-0.062)
Year fixed effects	YES	YES	YES	YES
Industry fixed effects	YES	YES	YES	YES
Obs. No.	990	990	990	990
Adjusted R^2	0.364	0.360	0.370	0.363